



EMERALD

## EMERALD ADVISERS, INC.

### 2013 4<sup>TH</sup> QUARTER ECONOMIC & PORTFOLIO COMMENTARY

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- Strong absolute fourth quarter returns drove the Russell 2000 to its fourth best performance year in its history.
- 2013's leaders turned to laggards in the fourth quarter as small capitalization stocks lagged large capitalization stocks, growth trailed value, the fastest earnings growth companies underperformed their slower growth counterparts and the healthcare sector performance stalled on a relative basis.
- Earnings across the all capitalizations are poised to accelerate in 2014, in conjunction with acceleration in global developed markets. We believe small capitalization stocks are particularly well positioned as the domestic economy accelerates and the cycle of innovation that has fueled earnings growth over the last three years continues unabated.
- With a lessening in political tension and the macro-economic backdrop looking more favorable this year than at any time in the last four years, we remain optimistic that earnings growth will lead the market higher this year. Emerald expects small capitalization to again post the highest earnings growth rates among the capitalization segments.
- The portfolio underperformed the Russell 2000 Growth index for the quarter driven by disappointing relative performance within the technology, healthcare and consumer discretionary sectors. For the full year, Emerald outperformed the benchmark led by stock selection within the healthcare, consumer discretionary, energy and financial services sectors.

This year, the market, the economy, the consumer and the investment community made a significant amount of progress toward putting the financial crisis in the rearview mirror. The S&P 500 index rose 32.4% during 2013, notching the largest gain since 1997. Significant gains in the equity market and in housing values helped to further solidify the consumers' balance sheet, giving consumers the confidence to again invest in new homes, remodel their existing homes and buy new cars at rates we haven't experienced since the financial crisis began in 2008. At the corporate level, strong gains in the equity markets have also helped the average pension fund make significant progress toward regaining their funded status. According to Towers Watson, pension funding levels for 418 of the Fortune 1000 companies, rose to 16 percentage points to end the year at 93%. While still not the 100% funding achieved in 2007, the path to full funding appears much more attainable given recent market gains. Strong gains in the market has also helped drive an acceleration in deal activity with domestic merger and acquisition activity increasing 11% year over year and surpassing \$1 trillion in deal value. Again, representing the highest levels achieved since the start of the financial crisis. The initial public offering market similarly accelerated with the total number of companies coming public increasing 59% to 230 and the amount raised climbing 31% to \$62 billion, levels that haven't been witnessed since 2007.

Further, the resolution of the government's action against the major banks associated with mortgage lending with the record \$13 billion settlement with JP Morgan as well as the government's crackdown on insider trading with the landmark case against SAC Capital should also go a long way toward restoring investor confidence in the integrity of the market. So too, should the wind-down of the Troubled Asset Relief Program (TARP). On December 30, the U.S.

Treasury Department announced that it had made significant progress towards completing the wind down of the TARP program. The Treasury fully exited the taxpayers' investment in General Motors, recovered an additional \$5.9 billion of the investment in Ally Financial and substantially reduced the remaining bank investments. According to the Treasury, 40 banks repaid taxpayers and the Treasury auctioned or otherwise sold positions in 81 institutions. All of these actions, through December 30 have resulted in the Treasury recouping \$432.8 billion on all TARP investments, reflecting a gain from the \$421.9 billion it disbursed. After all of the negative press, the U.S. taxpayers should be comforted to know that their investment in the U.S. financial institutions actually made them money.

All of these facets combined with a stable domestic economy, a more benign political climate, an improving European economic outlook, tensions in the Middle East having settled after flaring mid-year and the acceptance of the reality of the taper have collectively united to limit volatility, drive the equity risk premium lower and price to earnings multiples higher throughout 2013. The climate of 2013 was particularly favorable for small capitalization stocks driving a 38.8% return for the Russell 2000, the index's fourth best year. Within small caps, the growth style was a particular standout, with the Russell 2000 Growth surging 43.3% for the year, topping the Russell 2000 Value's 34.5% gain.

After such a strong year of performance, the fourth quarter, although absolute returns remained solidly positive, provided a bit of a relative give back as leaders turned to laggards. Small caps lagged large cap, the growth style lagged value, biotechnology industry trailed, and those companies with the fastest earnings growth rates lagged after leading returns for the year. Emerald's performance similarly was challenged on a relative basis. In a departure from our typical trends, relative performance for the fourth quarter was most impacted by interaction effect rather than stock selection. Interaction effect detracted from performance as the portfolio's overweighted sectors (consumer discretionary, healthcare and technology) underperformed due to challenging stock selection while at the same time the portfolio's underweighted sectors (material and producer durables) recorded positive stock selection, essentially neutralizing the impact of stock selection for the portfolio in aggregate in the quarter.

#### **Portfolio Positioning:**

At the sector level, holdings within the materials sector of the portfolio were the most significant positive contributor to return during the quarter. As leaders turned to laggards, laggards also turned to leaders. This was true within the materials sector of the portfolio. Strong stock selection was the key driver of the relative outperformance. Although the portfolio in aggregate remains underweight the materials sector, Emerald has been selectively adding exposure to this sector throughout the quarter and is becoming increasingly optimistic about the opportunity set, specifically as it relates to those companies poised to benefit from an acceleration in the non-residential construction market.

Additionally, while sector level contribution was essentially neutral for the quarter within the energy and financial services sector, at the industry level the portfolio experienced notable relative outperformance within both the crude producers and banking industries, continuing the trend of year-to-date outperformance. Positive contribution from the aforementioned was, however, offset by relative underperformance within the technology, healthcare and consumer discretionary sectors.

The fourth quarter proved to be challenging within the technology sector of the portfolio, driven by a few earnings disappointments within the software industry. Although disappointed with the fourth quarter relative performance within the technology sector, as we look to 2014 Emerald is optimistic about the opportunities within the technology sector. Emerald has added exposure to the sector throughout the quarter due to what we view as a broadening opportunity set. The software industry and security focused companies in particular, have become an area of increasing emphasis as guarding against cyber-attacks, given their growing in rate of occurrence, has become a key area of focus within the enterprise. The customer data theft at Target where the credit card information of more than 40 million customers was compromised as a result of cyber theft is a case in point. Further as we enter 2014, Emerald continues to believe that network infrastructure is poised for a significant transition towards advanced optical technologies. As current infrastructure within both telecommunications networks and data centers is being pushed to unsustainable levels, the transition to advanced technologies is becoming increasingly necessary. Additionally, continued secular trends such as the BYOD phenomenon within the enterprise and emerging trends such as the "Internet of everything" will increase network complexity, further exacerbating the need to upgrade infrastructure. Emerald believes our

portfolios are well positioned to participate in these emerging trends. The technology sector represented the portfolio's largest relative overweight position as of quarter-end.

Performance was similarly challenged within the healthcare sector. After leading performance during the first three quarters of 2013, returns within the healthcare sector lagged that of the benchmark primarily as a result of stock selection within the biotechnology industry. As we look to 2014, the biotechnology industry remains a key area of emphasis and overweight as Emerald continues to be encouraged by the pace at which the FDA is allowing companies who are pursuing novel medications to press forward in clinical development. Emerald continues to favor companies that save the healthcare system money, companies that lack reimbursement concerns, and companies with revolutionary new products that can withstand the scrutiny of payers.

The Consumer Discretionary sector was also challenging in the fourth quarter. On the plus side, Emerald realized strong performance in the leisure time industry. Offsetting the positive contribution from the leisure time industry was the relative underperformance in the specialty retail industry. As we look to 2014 Emerald remains focused on identifying niche opportunities within the consumer discretionary sector. The portfolio as of quarter-end was approximately equal-weight the consumer discretionary sector.

### **Market Outlook:**

As we reflect on those factors that drove performance in 2013 and look to 2014 we continue to be optimistic regarding the opportunity for growth stocks and small capitalization stocks in particular. Earnings across the all capitalizations are poised to accelerate in 2014, in conjunction with acceleration in global developed markets. The domestic macro-economic backdrop is looking increasingly favorable as economic data has broadly shown improvement. If these trends hold, we believe 2014 could also usher in a reacceleration in domestic capital investment, which could be another point of upside. Strength in the domestic economy bodes particularly well for small capitalization stocks. So too does the continuation of the innovation cycle that has fueled earnings growth over the last three years and we believe remains strong and unabated. Our optimism is predicated on the breadth of the opportunity set, from biotechnology, medical devices, exploration and production, software (cloud delivery) and security to new retail and restaurant concepts coming to market and everything in between. Encouragingly, innovation in our view continues to thrive. The initial public offering (IPO) market in 2013 returned to levels not seen since 2007. While last year's IPO market was strong we believe the 2014 pipeline looks similarly attractive, with several notable technology companies slated to come public. Small capitalization stocks, in our opinion, have, and continue to be, at the epicenter of this innovation cycle.

The market backdrop is looking similarly attractive. With the developed economies broadly on better footing, a domestic political climate that should be more benign, Janet Yellen at the head of the Federal Reserve, zero rate interest policy firmly entrenched and the tapering of the Federal Reserve's bond buying program now in progress, there appears to be less uncertainty entering 2014. With a lessening in political tension and the macro-economic backdrop looking more favorable this year than at any time in the last four years, we remain optimistic that earnings growth will lead the market higher this year. Emerald expects small capitalization to again post the highest earnings growth rates among the capitalization segments.

As always, Emerald remains focused on utilizing its fundamental bottom-up research process to identify the best growth opportunities within the small capitalization universe. Exiting 2013, the portfolio remains positioned in the best growth opportunities which are reflected at the sector level in overweight positions in the technology, financial services and healthcare and the most significant underweight positions in the consumer staples, producer durables and materials sectors.

*- January 13, 2014*